Supreme Court, U. S.
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IN THE

Supreme Court of the United States

October Term, 1978

No. 78-746

EVA GROSSMANN,

Petitioner,

vs.

EDWARD S. REDINGTON, Trustee, and SECURITIES INVESTOR PROTECTION CORPORATION,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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EVA GROSSMANN, *Petitioner,*

vs.

EDWARD S. REDINGTON, Trustee, and SECURITIES INVESTOR PROTECTION CORPORATION, *Respondents.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The petitioner Eva Grossmann respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit entered in this proceeding on June 12, 1978.

OPINIONS BELOW

The opinion of the Court of Appeals, not yet reported, appears in the Appendix hereto* at pages A1-A16. The opinion of the District Court is reported at 425 F. Supp. 212 and appears in the Appendix hereto at pages A19-A32. The opinion of the Bankruptcy Judge is unreported and appears in the Appendix hereto at pages A33-A40.

JURISDICTION

The Judgment of the Court of Appeals for the Second Circuit was entered on June 12, 1978. A timely petition for rehearing *en banc* was denied on August 7, 1978 (A17-A18), and this petition for certiorari was filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

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*The Appendix is bound in a separate volume.

QUESTIONS PRESENTED

1. May the Securities Investor Protection Act, which is an integral part of the comprehensive securities regulation system enacted by Congress for the purpose of protecting investors, be interpreted in such a manner as to harm innocent defrauded investors in contravention of congressional policy and decisions of this Court?

2. May the illegal actions of a securities broker and the New York Stock Exchange's wrongful approval of a sale of securities which is plainly prohibited by an applicable securities regulation, divest an innocent unsophisticated investor of the insurance which Congress has established for the purpose of protecting investors?

3. May the securities regulatory system which Congress created for the purpose of protecting investors, profit from its own wrongful conduct at the expense of an innocent unsophisticated investor?

4. When a stock exchange issues rules and regulations pursuant to statutory requirements, may a court selectively and discriminatorily enforce one of the exchange's rules, but refuse enforcement of another equally important exchange rule, designed to protect a financially unsophisticated investor, which has been breached by the exchange itself to the detriment of such an investor?

5. May innocent unsophisticated investors who have been defrauded by an unscrupulous securities broker be deprived of their common law and state statutory remedies by a rigid and restrictive interpretation of the Securities Investor Protection Act?

STATUTORY PROVISIONS AND REGULATIONS INVOLVED*

15 U.S.C. § 77p

15 U.S.C. § 77r

15 U.S.C. § 78f

15 U.S.C. § 78bbb

15 U.S.C. § 78ccc

15 U.S.C. § 78ddd

15 U.S.C. § 78fff

15 U.S.C. § 78iii

New York Stock Exchange Rule 325

New York Stock Exchange Rule 325.20

New York Stock Exchange Rule 405

Illinois Revised Statutes, ch. 121½ § 137.12

Illinois Revised Statutes, ch. 121½ § 262

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* These statutory provisions and regulations are set forth in the separately bound Appendix to this petition.

STATEMENT OF THE CASE

William J. Scott, Attorney General of the State of Illinois, files the present petition on behalf of petitioner, Mrs. Eva Grossmann, an Illinois citizen and resident who has been defrauded by an unscrupulous securities broker. He files this petition because the issues raised herein are of grave concern to all the citizens of the State of Illinois and to the entire nation.

Petitioner, a native of Romania, immigrated to the United States with her husband in 1950 (A 72). She found a job as a fitter in a Chicago department store where she is still employed. In 1967, shortly after the death of petitioner's husband, a Mrs. Meiselman, one of the store's customers who was aware of petitioner's circumstances, told petitioner to consult her husband, Mr. Leo Meiselman, executive vice-president of Weis, Voisin, Cannon, Inc., in Chicago. Mrs. Meiselman told petitioner that Mr. Meiselman had successfully invested funds for several widows and would help and advise her in investing her money (A 73). Petitioner thereupon consulted Mr. Meiselman and, at his direction, turned over first her entire life savings of $15,000 to Weis, Voisin, Cannon, Inc., and later $5,000 which petitioner had received from a life insurance policy on her husband's death (A 73).

In return for the $15,000 she received a letter from the broker acknowledging receipt of this amount; the letter stated that the funds were "to be used to purchase two-year debentures . . ." (A 66). Nothing was mentioned about any "subordinate" debenture. Around that time petitioner received a certificate entitled "WEIS, VOISIN, CANNON, INC. TWO YEAR DEBENTURE BOND" for $15,000. Nothing in the caption indicated that the debenture was

subordinate. Only in the second paragraph of the document was there a mention made, IN FINE PRINT, of a subordination clause (A 67). Mr. Meiselman never explained or even mentioned a subordination clause (A 63, A 73) and even if petitioner had read the fine print she would not have comprehended its significance (A 73). Petitioner was completely naive and uneducated in financial matters and relied solely upon the advice and direction of Mr. Meiselman (A 73). All papers signed by petitioner, including the application to the New York Stock Exchange for approval of subordinate status (which petitioner did not understand but thought related to proof of citizenship), were signed by her solely, and in complete reliance on Mr. Meiselman's advice and pursuant to his direction (A73-A 74).

As to the $5,000 she never received a debenture certificate but merely a receipt acknowledging her check in the amount of $5,000 "for Debenture Account of Customer" with no mention, even in fine print, of a subordination clause (A 68).

The debentures were automatically renewed by the brokerage firm (A 63). Weis, Voisin, Cannon, Inc., was subsequently sold to or taken over by a different corporate entity, Weis Securities, Inc., the present bankrupt; however, petitioner never received any notification of the takeover and for the first time learned of it through a letter sent to her by Weis Securities, dated April 27, 1973, informing her that the firm's auditors were making an examination of the firm's financial statements and that she should confirm her subordinate debenture account in the amount of $20,000. Shortly thereafter, liquidation proceedings were commenced against Weis Securities, and she read in a newspaper of the firm's bankruptcy (A 75). The liquidation proceedings against Weis Securities were instituted

by the Securities Investor Protection Corporation in May, 1973, under the Securities Investor Protection Act of 1970.

The Trustee has taken the position in the liquidation proceedings that all so-called subordinate debenture holders, including petitioner, must be treated alike, regardless of any fraud practiced upon them, and that they are estopped from rescinding their subordinated loan agreements embodied in the debentures. In pursuance of that theory, he moved for a summary judgment which was denied by the Bankruptcy Judge because of the existence of material questions of fact (A 40).

The District Court reversed the Bankruptcy Judge and the Circuit Court affirmed the District Court. Petitioner was treated by the District Court and the Court of Appeals as if she had been a sophisticated investor, equating her status with that of the other subordinate debenture holders involved in the present liquidation proceedings, who, unlike petitioner, were large investors well versed in financial matters.

REASONS FOR GRANTING THE WRIT

I.

THE LOWER COURTS' SUMMARY DENIAL OF PETITIONER'S CLAIM CONTRAVENES THE POLICIES WHICH CONGRESS HAS DECLARED VITAL TO THE NATION'S ECONOMY.

The importance of the instant case involving the liquidation of a bankrupt brokerage firm far transcends the claim of petitioner. It is a case of first impression and raises issues of grave national concern which should be decided by this Court because they affect directly the nation's economy. The lower Courts' refusal to grant petitioner the protection which Congress, under the Securities Investor Protection Act (hereinafter SIPA),[1] intended to afford investors of brokerage firms in liquidation, is destructive of the public confidence in the securities markets which both this Court and Congress have recognized essential to the economic health of our nation. *Securities and Exchange Comm.* v. *Capital Gains Research Bureau,* 375 U.S. 180, 201, 11 L. Ed. 2d 237, 252 (1963); House Report No. 91-1613; 91st Cong. 2d Sess. (1970), 3 U.S. Code Cong. & Adm. News 5254, 5255 (1970).[2]

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1. 15 U.S.C. § 78 aaa *et seq.*

2. The House Bill was passed in lieu of the Senate version.

A.

History And Purpose Of Securities Regulations

The Securities Act of 1933[3] and the Securities and Exchange Act of 1934[4] were designed to eliminate certain abuses in the securities industry which had contributed to the stock market crash of 1929 and the depression of the 1930's. *Securities and Exchange Comm.* v. *Capital Gains Research Bureau, supra* at 375 U.S. 186. "The primary purpose of the 1934 Exchange Act was to protect customers of the stock exchanges—that is public investors." *Lank* v. *New York Stock Exchange,* 548 F. 2d 61 (2d Cir. 1977). The method used was to impose a statutory duty upon the exchanges to protect investors by regulating the exchanges' members, with the federal government (through the SEC)[5] retaining the power to step in only when an exchange failed to regulate its members in a manner that adequately provided protection to investors. *Silver* v. *New York Stock Exchange,* 373 U.S. 341, 352, 10 L. Ed. 2d 389, 397, *reh den* 375 U.S. 870, 11 L. Ed. 2d 99 (1963).

Subsequently, Congress enacted the Securities Investor Protection Act of 1970 (SIPA) for the primary purpose of providing "protection for investors if the broker-dealer with whom they are doing business encounters financial troubles." House Report No. 91-1613, 91st Cong. 2d Sess. (1970), 3 U.S. Code Cong. & Adm. News 5254, 5255 (1970).

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3. 15 U.S.C. § 77a *et seq.*

Securities Acts citations are to the Acts as they existed prior to the Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (June 4, 1975). The essential regulatory scheme remains the same today.

4. 15 U.S.C. § 78 a *et seq.*

5. Securities and Exchange Commission.

This House Report discloses that the principal reasons why SIPA was needed and enacted were as follows: 1) while the rules and regulations enforced under the 1934 Exchange Act provided "important protection for investors, it is clear that these rules are not sufficient by themselves to prevent the exposure of customers to substantial risk of loss as a result of financial mismanagement by a firm or its employees or insolvency." *Id.* at 5256; and 2) the financial failure of a substantial number of brokerage houses resulted in the loss of investors' funds with a corresponding weakening of confidence in the U.S. securities markets, and such lessened confidence has an adverse effect on the entire economy. *Id.* at 5255.

SIPA provides additional protection to investors and retains all of the safeguards for investors which existed at the time of its enactment. Section 2 of SIPA[6] expressly provides that the 1934 Securities Exchange Act shall apply as if SIPA "constituted an amendment to, and was included as a section of such Act."

Section 3 of SIPA[7] creates the Securities Investor Protection Corporation (hereinafter SIPC). In a liquidation proceeding of a brokerage firm, SIPC is supposed to pay, within its statutory limits, the amount of customers' losses from a fund which SIPC collects from all securities dealers registered under the 1934 Securities Exchange Act (much in the way that the Federal Deposit Insurance Corporation protects depositors of banks). *Securities and Exchange Comm.* v. *F. O. Baroff Co., Inc.*, 497 F. 2d 280, 281 (2d Cir. 1974); House Report No. 91-1613, *supra* at 5255.

For the reasons set forth below, the lower courts' refusal to afford petitioner the status of "customer" under

6. 15 U.S.C. § 78 bbb
7. 15 U.S.C. § 78 ccc

SIPA violates the intent of Congress; renders the protection which Congress created illusory and meaningless; allows the system which has a statutory duty to protect investors to profit from its wrongful acts at the expense of innocent investors; and weakens confidence in U.S. securities markets with the inevitable adverse effect on the national economy.

B.

The Securities Investor Protection Act Must Be Construed In A Manner Which Will Provide Meaningful Protection To Investors.

Petitioner, a fitter in a Chicago department store, a Romanian immigrant completely unsophisticated and uneducated in financial matters, was told by one of the store's customers who was aware of the recent death of petitioner's husband, to contact Mr. Leo Meiselman, executive vice president of the brokerage firm of Weis, Voisin, Cannon, Inc. The customer, who was the wife of Mr. Meiselman, told petitioner that her husband had successfully invested funds for several widows. Petitioner then consulted Mr. Meiselman, and being completely ignorant in investment matters, relied totally upon his expertise and advice. At Mr. Meiselman's direction she turned over $20,000.00 to his brokerage firm. This sum consisted of her entire life savings of $15,000.00 plus $5,000.00 life insurance proceeds which she had received upon the death of her husband.

Weis, Voisin, Cannon, Inc., was a member of the New York Stock Exchange (hereinafter NYSE), and Mr. Meiselman, in blatant violation of NYSE Rule 405,[8] invested petitioner's entire life savings in subordinate debentures of his

8. SEC Rule 15 b 10-3 is a comparable rule which applies to broker dealers who are not members of an exchange.

own brokerage firm. NYSE Rule 405, often referred to as the "suitability" or "know your customer" rule is supposed to prevent brokers from inducing unsophisticated small investors to invest a large portion of their total assets in investments which are speculative and/or not adequately secured. It is an integral part of SEC regulation. *Starkman* v. *Seroussi,* 377 F. Supp. 518, 524 (S.D.N.Y. 1974).

In *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith Inc.,* 410 F. 2d 135 (7th Cir. 1969), *cert. denied* 396 U.S. 838 (1969), the Court held that the purpose of NYSE Rule 405 was to protect the public and a violation of it by a member broker was actionable, constituting a violation of Section 6 of the Securities Exchange Act of 1934.[9] The SEC expressed concern over the very type of transaction by which petitioner was defrauded in the present case. In Securities Act Release No. 5215, Exchange Act Release No. 9412 [1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78, 455 (Dec. 9, 1971), referring to the efforts of some broker-dealers to persuade prospective customers "to subordinate their securities accounts to the claims of other customers and the general creditors of such broker-dealers", the SEC cautioned that such solicitations "may also result in violation of the anti-fraud provisions of the Securities Act and the Exchange Act, and of the regulations thereunder."

Although section 6 of the Exchange Act placed a duty upon the NYSE to enforce Rule 405 against Weis, Voisin, Cannon, Inc., the NYSE, rather than enforcing the rule, participated in its violation. It approved a subordinate debenture application for a total sum of $20,000, in which a widow working as a fitter for her livelihood, upon the broker's prodding, had stated in her application that her total financial worth was $30,000, which included her furniture, etc. The NYSE thereby acted in crass contravention of its responsibilities by wrongfully approving the sale of subordinate debentures to petitioner so that petitioner's money could be used by the firm to help it meet net capital requirements (NYSE Rule 325). NYSE Rule 325.20 provides, among other things, that subordinate debentures constitute unencumbered capital assets, enabling the broker to continue to deal with the public.

9. 15 U.S.C. § 78 f.

The lower courts discreetly ignored the violation of the suitability rule (NYSE Rule 405) and based their decisions exclusively on the net capital requirements rule. It is respectfully submitted that such arbitrary selective enforcement of rules is highly improper. This is particularly true in the instant case because the net capital rule finds no application to an investor's funds which have not been lawfully subordinated. Since the sale of subordinate debentures to petitioner was plainly prohibited by NYSE Rule 405, it could not alter petitioner's legal status, and because petitioner never occupied the legal status of a subordinate lender, the net capital rule has no application to her claim.

The term "customer" as used in SIPA is synonymous with that of investor. *Securities and Exchange Comm.* v. *F. O. Baroff Co., Inc.,* 497 F. 2d 280, 283 (2d Cir. 1974). There can be no dispute over the fact that when petitioner gave her life savings to the brokerage firm she was a "customer" protected by SIPA[10] and entitled to the insurance protection of SIPC[11] if the broker was placed in li-

10. SIPA § 6(c)(2)(A)(ii and iii), 15 U.S.C. § 78 fff (c)(2)(A)(ii and iii).

11. SIPA § 6(f)(1), 15 U.S.C. § 78fff(f)(1).

quidation. She, as an innocent unsophisticated victim, may not be stripped of this protection by the wrongful and illegal acts of the broker and the NYSE.

It is axiomatic that all statutes are to be construed in a manner that implements the true spirit and intent of the legislature; when a literal reading produces a result which is at variance with the policy of the legislation as a whole, it is the purpose of the statute that controls. *United States* v. *American Trucking Assoc.*, 310 U.S. 534, 543-544, 84 L. Ed. 1345, 1351 (1940). Securities legislation, enacted to protect the public from fraudulent practices, should not be construed technically and restrictively, but flexibly to effectuate its remedial purposes. *Securities and Exchange Comm.* v. *Capital Gains Research Bureau*, 375 U.S. 180, 194-195, 11 L. Ed. 2d 237, 247-248 (1963).

The opinions of the District and Circuit Court are based upon a strict literal interpretation of SIPA § 6(c)(2)(A)(ii) and are therefore in conflict with the above cited Opinions of this Court. By allowing an unscrupulous securities broker's illegal actions and an exchange's wrongful conduct, to strip an innocent unsophisticated investor of the protection which Congress intended to, and did confer upon the investor, the District and Circuit Courts have encouraged the very type of conduct which the securities laws are designed to prevent. By those decisions the protection which the securities regulations were designed to afford were rendered meaningless and illusory.

C.

The Securities Regulatory System May Not Profit From Its Own Wrongful Conduct At The Expense Of An Innocent Unsophisicated Investor.

As previously discussed the New York Stock Exchange (NYSE) and the Securities Investor Protection Corporation (SIPC) are integral parts of a single system which Congress created to protect investors. The NYSE, under the authority granted by Section 6 of the Securities Exchange Act, is supposed to protect investors by regulating the conduct of its members through its enforcement power. When regulation is insufficient to adequately protect investors, SIPC, out of its fund, is supposed to reimburse investors' losses up to the statutory limit. Since the basic source of the SIPC fund consists of member assessments[12], which NYSE collects as agent for SIPC,[13] it is obvious that Congress intended the brokerage industry itself, through SIPC, rather than the innocent victimized investor, to bear the losses resulting from broker-dealers' insolvencies.

In the present case petitioner's loss of her entire life savings occurred as a direct result of the NYSE, the enforcement arm of the system, both permitting and wrongfully approving an illegal act against an innocent, unsophisticated investor. The District and Circuit Court opinions, which deny petitioner customer protection, permit the insurance branch of the system to profit from the wrongful acts of the enforcement branch at the expense of innocent investors.

SIPC will not only retain the monies which Congress intended petitioner to have, but SIPC will actually receive a larger portion of the money which the broker fraudulently obtained from her than any other creditor. SIPC, as subrogee of customers' claims it has paid,[14] has claims of more than thirteen times the combined amount of the unsatisfied claims of all other customers.[15] Since included in

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12. SIPA § 4(c), 15 U.S.C. § 78ddd. § 4(c).
13. SIPA § 9(a), 15 U.S.C. § 78iii § 9(a).
14. SIPA § 6(f)(1), 15 U.S.C. § 78fff(f)(1).
15. This figure is taken from page 29 of the brief respondents filed in the Second Circuit Court of Appeals.

the assets of the brokerage firm is the money which was illegally obtained from petitioner, under the lower Courts' decisions SIPC will profit more than any other party from NYSE's wrongful approval of an illegal securities sale, and this profit will be at the expense of an innocent investor.

In *Silver* v. *New York Stock Exchange,* 373 U.S. 341, 364, 10 L. Ed. 2d 389, 404 (1963), this Court, discussing the self-regulation of the securities industry, said:

> Congress in effecting a scheme of self-regulation designed to insure fair dealing cannot be thought to have sanctioned and protected self-regulative activity when carried out in a fundamentally unfair manner.

The result reached here is not only fundamentally unfair and legally untenable, but it exacerbates the industry regulation problem. While it is desirable to protect the SIPC fund, it should be protected by better industry regulation which will result in fewer investors' losses. Allowing the brokerage industry to profit from its own wrongful acts will only encourage their repetition and lax regulation. The ramifications of such a result are obvious and, it is respectfully submitted, should be rectified by this Court.

D.

The Lower Courts' Summary Denial Of Petitioner's Common Law And State Remedies Erroneously Deprived Petitioner Of Remedies Which Congress Plainly Preserved.

The enactment of SIPA did not destroy Petitioner's right to utilize her common law and state statutory remedies entitling her to the return of the money of which she was illegally deprived. All laws promulgated for the protection of the securities investor are in *pari materia* and

must be read together. Section 16 of the Securities Act of 1933 (15 U.S.C. § 77p) declares expressly that the rights and remedies provided in the statutes dealing with the protection of securities investors and holders "shall be in addition to any and all other rights and remedies that may exist . . . at law or in equity". The lower courts have completely ignored that statutory provision by denying, in a summary fashion, any relief to petitioner to which she had been entitled due to the fraud and deceit practiced by the broker. In particular, the Court of Appeals misapprehended the whole theory of a constructive trust by holding that there was no *res*—a segregated fund or property—to which the trust could attach. In making that determination, the Court simply ignored well established principles of law as well as its own previous decisions and those of other circuits. The *res* in a constructive trust instance is any fund in which the moneys of the wronged party have been placed, even though the wrongdoer had commingled these moneys with its own or those of other persons. Although the constructive trust as a "fraud-rectifying" device becomes effective only by imposition of the courts, it relates back to the time of the original wrongdoing. Here the Trustee has admitted that the petitioner's moneys became part of the broker's working capital. Some of that capital was in existence at the time of the commencement of the liquidation proceedings, and still is. Under these circumstances, petitioner is entitled to either a portion of the commingled fund proportioned to her contribution thereto, or to an equitable lien on the entire fund for the amount of her money. *Marcus* v. *Otis,* 168 F. 2d 649, reaff'd 169 F. 2d 148 (2d Cir. 1948); *In re Blue Bird Appliance Co.,* 292 F. 127, 128 (8th Cir. 1923); *Grodsky* v. *Sipe,* 30 F. Supp. 656 (E.D. Ill. 1940); *Primeau* v. *Gran-*

field (decision by Judge Learned Hand), 184 F. 480 (S.D.N.Y. 1911), *rev'd on another ground* 193 F. 911 (2d Cir. 1911), *cert. den.*, 225 U.S. 709 (1912); *Erie Trust Company's Case,* 326 Pa. 198, 191 A. 613 (1937); *Burket* v. *Bank of Hollywood,* 9 Cal. 2d 113, 69 P. 2d 421 (1937); *In re Oatway,* [1903] 2 Ch. 356; Rest. Restitution § 209.

The denial of a constructive trust by the lower courts in the present case constitutes a violation of the policies and principles envisaged by Congress in enacting the various securities laws since Congress intended that the defrauded investor should have the whole arsenal of common law remedies available to him in order to avert the detrimental effect of securities frauds upon the economy.

Moreover, the practices engaged in by the stockholder were also violative of pertinent Illinois State statutes. Under Section 18 of the Securities Act (15 U.S.C. § 77r), state authorities may exercise concurrent jurisdiction with the federal authorities; hence the pertinent provisions of the Illinois Securities Law (Ill. Rev. Stat. ch. 121½, § 137.12) and the Illinois Consumer Fraud Act (Ill. Rev. Stat. ch. 121½, § 262) are equally applicable with regard to the activities of the stockbroker who engaged in the deceitful practices. (See *Merrill Lynch, Pierce, Fenner & Smith Inc.* v. *Ware,* 414 U.S. 117, 123, 128, 129, 130, 137, 38 L. Ed. 2d 348 ,359, 360, 361, 364, 365 (1973); *Crosby* v. *Weil,* 382 Ill. 538, 48 N.E. 2d 386 (1943); and *Travelers' Health Assn.* v. *Comm.* 188 Va. 877, 51 S.E. 2d 263 (1949), *aff'd.* 339 U.S. 643, 94 L. Ed. 1154 (1950). Here again, the lower courts, in denying petitioner's claim, in effect, deprived petitioner of remedies which Congress in its securities regulations plainly preserved.

CONCLUSION

Since the public interest is vitally affected and the decisions of the lower courts are fraught with grave consequences, particularly for the small, unsophisticated investor in the securities market, and, therefore, the national economy—consequences which by far transcend the factual confines of the case at bar—it is respectfully asked that a writ of certiorari be issued to review the judgment and opinion of the Second Circuit.

Respectfully submitted,

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